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American Institute of Certified Public Accountants

MANAGEMENT SERVICES BY CPAs

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The Review of the Management Controls of the Small Business

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS 1961

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To the reader

§ The plight of small business, caught in a vise of rising costs and declining profits, has produced more tears than a score of soap operas.

§ Everyone, as Mark Twain did *not* say, talks about the problem; but no one does anything about it.

§ Well, hardly anyone. More and more certified public accountants are coming to the aid of hard-pressed small business clients. This is not surprising. The regular work of a CPA—whether monthly "write-up" engagements or "opinion" audits—admirably places him in a position to render assistance.

§ But how should a CPA approach the task of aiding management to manage better? How does he proceed to identify the business sins of commission and omission which boost costs or depress profits? How does he then persuade the client to recognize the need for additional services?

§ This bulletin provides some answers to these and similar questions. It is, in effect, a short guide to assist the CPA in finding opportunities for service to small business clients through review of their management controls.

The Review of the Management Controls of the Small Business

Introduction

THIS BULLETIN SHOWS how a review of the management controls of a small business may become a logical and continuous extension of the CPA's regular work. It is intended to provide CPAs with ideas as to how they may get started in management services work by uncovering control deficiencies in the small businesses, thereby creating additional opportunities for service to management and increasing the profitability of their small business clients.

Particular emphasis is placed on how the review of management controls may best be conducted, and specific examples are provided of how control deficiencies may be located through the organized use of resources readily available to every CPA.

THE REVIEW OF MANAGEMENT CONTROLS—
ITS BENEFITS AND PITFALLS
WHAT IS A REVIEW OF MANAGEMENT CONTROLS?

A REVIEW OF MANAGEMENT CONTROLS by CPAs can be defined simply as an extension of the CPA's regular work for the purpose of examining and assessing the adequacy of management policies, directives and procedures, which together constitute the system of management controls, to determine that they produce optimum operational efficiency—the logical result of which is maximization of profit.

What is meant by the CPA's regular work?

A READER SHOULD NOT quickly assume that "regular work" necessarily means a financial audit leading to an opinion. Regular work, as used here, means only the *usual work of the CPA,* whether it be the annual opinion audit of his largest client or the monthly write-up for his smallest.

Where are reviews of management controls most needed?

THE SMALL BUSINESS without depth in numbers of management personnel is logically the most vulnerable to breakdowns in management controls, if indeed adequate controls exist at all. The independent CPA's inspection of the existent controls and resulting practices may be the only testing they receive in the small business.

A review of management controls of a larger business more often serves to appraise and evaluate controls which management has already adopted and is continually inspecting. In a smaller business, review will often lead to the establishment of controls which management has not previously seen as necessary. The review of management controls can be a value to any client, but it is likely to be of most value to the client, and hence to the CPA, when the client is a smaller business—one without a controller, internal audit staff, or other specialists.

How does management benefit from the CPA's review?

THE PRIMARY OBJECTIVE of management is to make profit. It is sometimes questioned whether the annual financial audit, or the monthly write-up contributes very much to management's profit objective, or whether, at best, it merely informs them of the job they did—rather than how to do it better. The value to management of a review of management controls, performed as a supplement to the regular work, is illustrated by a story related by a practicing CPA.

"When I was a bag-carrying junior," he says, "I will always recall one supervisor to whom I was often assigned. On every audit, he would quickly delegate the audit tasks and disappear into the president's office where he would spend several hours. Curiosity ultimately impelled me to mind my supervisor's business and ask him what he talked about for such long periods."

"I talk about their inventories, young man," he said. "Don't you know that every president likes to talk about his inventories, and particularly to someone who is familiar with his problem, understands what he's talking about, and can exchange ideas with him?"

This simple story not only helps to define what is meant by reviewing management controls, but points up briefly its overall value to management—that of the independent CPA identifying himself with management operations and controls which clearly affect profits. The CPA's regular work, in itself, can rarely contribute to future profitability—unless it is used as a vehicle for uncovering profit potentials.

What are these potentials? They abound in virtually every business.

A recent survey discloses that many CPAs are now formally aiding managements in most of the operational or administrative areas of the business, many of which are performed in areas distinctly detached from those in which the CPA customarily works. Profitability has been enhanced in these cases as the result of a CPA *locating a problem, reporting it to management* and then *assisting in its correction.* Discussion of some typical problem areas and the methods of uncovering, reporting and correcting such problems will be found later in this bulletin.

What are the benefits to the CPA?

IN A RECENT EDITORIAL in the *CPA,* John L. Carey, Executive Director of the American Institute of CPAs, discussed the difficulty of commanding fees for write-up work as high as those for auditing, tax, or management services engagements. Much write-up work is performed by CPAs for small business clients because there is simply no one else to do it. As such, the write-up is most often only a minor phase of what could be a more complete service. If extended to a review of management controls, it can become the conduit by which the CPA can discover and perform additional services which will command higher rates because of their greater contribution to profitability. The CPA's superior training and education can be demonstrated to his write-up client through the review of management controls and resultant management services. And the CPA may favor the growth of his practice by evaluating whether his present offerings provide as full a measure of service as he is capable of rendering.

There is evidence, moreover, that practitioners who are already reviewing management controls have experienced the following benefits:

1. *It raises the image and acceptance of the CPA in the eyes of his client and the entire business community.* It is often not difficult to destroy a profit-minded president's image of his CPA if he is subjected only to conferences wherein the out-of-balance condition of his subsidiary ledgers is discussed. Or, if his annual "management" letter discusses only such issues as unendorsed checks or unperforated vouchers, a busy manager is most likely to pass it along to the bookkeeper. As a result, the CPA will not only have lost an excellent opportunity to identify himself with the profit function of management and so obtain such recognition, but may have unknowingly contributed to the self-destruction of the manager's image of the CPA.

2. *It will raise the level of a CPA's practice as well as its profitability.* A review of management controls is a challenging undertaking for a CPA and its contributions to clients will be gratifying rewards for this extended service. The profitability to a CPA's practice, too, will increase directly or indirectly. If a specific management service engagement is obtained as a result of the review, a separate fee will result. If the effect of the review initially results only in the opportunity to provide counsel to management, the good will engendered will often find its way to higher fees for the regular work.

It will be the purpose of this bulletin, however, to encourage CPAs to attempt to serve management on a separate basis, for it is the experience of others that management services are best rendered on that basis—where commingling of attentions to various problems is avoided. In contrast, there is distinct evidence that "piddling around" in management services work, while better than nothing to both management and the CPA, can leave much to be desired in both quarters. For example, what real value accrues to the small business client that asks his CPA to spend five minutes in evaluating the adequacy of a new organization chart?

Management, generally, will not obtain the full potential of a

CPA's advice if the advice is provided only on the basis of superficial observation—and then too often forgotten when dispensed by the CPA as a mere adjunct to the audit comments. The CPA, too, that "piddles" can most often only provide a limited service, whereas the same advice, rendered on the basis of a special engagement, cannot help but extend to all facets of the problem and provide the best coverage of its solution.

Pitfalls in reviewing management controls

TOUCHING UPON "piddling" in management services logically leads, next, to the dangers to be found in the proposed extension of regular work. If a CPA is to extend his work to review of management controls, it follows that some discussion must follow as to which controls affecting which administrative or operational practices may logically be examined by the CPA. This leads to the first major pitfall in work of this type:

1. If a CPA undertakes to extend his review activity to *areas of the business with which he is not, or cannot become, completely familiar, or which involve operations that require a technical or specialized knowledge which the CPA does not possess, it will generally prove to be a mistake.* The findings of the review of management controls ordinarily should have their roots in the financial audit or other regular work. The nonspecialist CPA who gives management advice in manufacturing, sales or any other specialized area of the business will often find it difficult to obtain the confidence of management if his advice is not grounded in financial matters. Advice, not supportable by figures, or by a knowledge the client is confident the CPA possesses, is often wasted, as well as potentially dangerous to the client relationship. In short, the value of the review will be enhanced if the deficiencies located or recommendations made are traceable to the regular work and training of the CPA.

2. Another danger, which is perhaps similar in nature to the

foregoing, lies in *the method in which the review is conducted.* If it is not conducted on an organized, well-programmed basis, it can lead to trouble. This danger is present, particularly, when the CPA does not know in advance what he is looking for. The client's employees, for example, may feel the CPA is either on a "fishing expedition" or, in some cases, may feel that the CPA has been detailed by management to appraise the employees themselves. Further, if it is erroneously accepted by management that the CPA is "surveying" the entire business, watch out!

3. *Neglect of regular work in an effort to review management controls* is a pitfall that probably need not be spelled out. While an enthusiastic staff man may not be able to wait to try to uncover deficiencies in the practices and policies involved in, say, the credit and collection function, the regular work on the receivables must come first. It is not implied, of course, that regular work would be deliberately side-stepped in favor of the review—only that it could accidentally occur unless specific care is taken.

This point must be expanded in order to relate the review of management controls to the client's over-all system of internal control. A review of management controls, or its resultant recommendations, never compromises internal control: rather, its purpose is to appraise the over-all system of internal control and enhance its value. The American Institute of CPAs has defined the system of internal control as follows: "Internal control comprises the plan of organization and all of the co-ordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies."

The financial audit deals primarily with those aspects of internal control that "safeguard its assets" and "check the accuracy and reliability of its accounting data." It is generally concerned to a lesser extent with controls adopted to "promote operational efficiency and encourage adherence to prescribed managerial policies." The review of management controls primarily supplements these latter elements within the definition of internal control, but does so only by following the financial controls to the operating areas and to the controls which govern their activity. Thus, the review of management controls never bypasses, nor should its results weaken, the system of internal control. Rather, it may lead to expanding its total value—by determining whether it is adequate and effective in assisting management to achieve its profit objectives.

4. *One last pitfall—a CPA may believe that his discovery of a management control deficiency must, in turn, require his solution to the problem.* By erroneously holding this attitude, a CPA might disqualify himself from undertaking a systematic program of management control review in any area where he is doubtful of his own competence to provide a complete solution. For example, a CPA might hesitate to appraise the potential of a cost system if he does not feel capable of installing his own recommendation. This would mean setting up an unnecessary barrier to getting started at all in management services work.

The emphasis in the review of management controls is *on the location of the problem,* for its basic purpose is to identify and signal the practices or policies requiring improvement. The solution should be thought of as a separate second step, and if special training is required to solve the problem, it can generally be obtained either by further study by the CPA himself or by obtaining the assistance of others.

There is no reason for a CPA to deny this service to small business through self-imposed limitations resulting from inability to provide the solution to a problem he discovers. The important thing to the management of a small business is that the independent CPA point up the problem and recommend an approach to its correction. Correction may be possible by management itself, the CPA himself, or through the engagement of specialist CPAs.

Summary

There is no person in a better position than the CPA to assist a small business management in uncovering profit-making opportunities, for every management decision, practice, or policy ultimately finds its way into the financial records of a business. The CPA, if conscious of his ability to aid management through a continuous program of reviewing management controls, will not only find profit-making opportunities for his client but for himself as well. Each CPA should pause for a moment and assess his present contributions to his small business clients in the light of his abilities to do so and the opportunities that exist to expand his services.

HOW THE REVIEW OF MANAGEMENT CONTROLS IS CONDUCTED

THIS SECTION ILLUSTRATES how the review of management controls may be undertaken by the CPA. It will discuss the resources that are available to him—the things to look for—and the extent of his work.

The extent of the CPA's work

LET US CONSIDER the last question first. It has not been the intention of the first portions of this bulletin to create the impression that a CPA must uncover deeply obscured deficiencies in order to render a valuable service to management through reviewing its management controls. To the contrary, the purpose of this bulletin is to encourage only an examination of those areas into which the regular work normally extends and, more particularly, into *those areas with which a CPA is familiar, or with which he may quickly become familiar.*

It is, therefore, impossible to define for all CPAs what the review should cover. More correctly, perhaps, it should be stated that the stopping place is a point that cannot be defined, as the competence of each individual CPA in the various areas of specialized practice and business experience will dictate a different stopping place for each.

The factor of experience must be underscored. A CPA with practical experience in selling will more likely intensify his review of the management controls in that area of the business while, due to his own limitations, restricting the scope of his review of, say, the personnel function. But, as more experience is gained through (1) continually examining clients' personnel practices and, (2) further study of the subject, the CPA will equip himself to render a more valuable service to small business in this area and, of course, in any other area in which he undertakes the same program to gain experience and technical competence.

To summarize then—each CPA must determine his own stopping point, but there exists a starting point for all CPAs which, simply defined, is his regular work. And, in undertaking a review of management controls, a CPA can do well to remember that he need not be an expert in all areas of the business, anymore perhaps than the president of the company is expert in all of them.

The resources available to the CPA in reviewing management controls

THE PURPOSE OF THIS SECTION will be to encourage CPAs to better utilize those resources which will result in a more formal approach to the review, as well as a more thorough review. These resources are the staff, and review programs and questionnaires. There are, however, a few very basic resources of the CPA without which he could not undertake a review. These must be mentioned briefly.

The informal extension of the regular work wherein the right *state of mind,* coupled with the expenditure of a little *time* to ponder why things are not done in other ways, will occasionally produce a profit-making idea for a small business management. Therefore, these basic resources, consisting of investment of *time* and the application of *general business experience* which each CPA can offer his clients, must be mentioned. The utilization of these resources alone, however, generally results in what might be called the non-organized "feet on the desk review of management controls." It may, nevertheless, be more than some busy CPAs are now offering to small business clients. Even this informal approach could, therefore, hold a potential value to management. Experience dictates, however, that this informal approach represents a form of "piddling" in management services, for it exercises none of the formal tools by which the CPA may expand the scope and value of his review and conduct it on a more organized basis.

The more formal resources available to the CPA will be discussed in detail later in this chapter. The first of these is, of course, his staff. The next are formal programs of review, and questionnaires for use as guides in investigation. Another to be discussed is the management letter. Before a discussion of these, however, it is appropriate to consider how the review of management controls logically stems from the regular work. After illustrations have been given of what the CPA is looking for in his review of management controls, a further discussion of the resources that will expand the intensity and value of the review can more logically follow.

Illustrations of how review of management controls stems from regular work

If an imaginative CPA or staff man habitually adopts a "management state of mind" during the course of his regular work, there are many possibilities for locating opportunities for special services to management. Extension of all of the elements of the CPA's usual work cannot be covered in this bulletin, but by covering some of them, the point of what is being looked for in the review of management controls can be illustrated. For purposes of example, areas with which the CPA will almost always come into contact have been selected for discussion.

Cash. First, the audit of cash—whether for the annual audit of one of the country's "blue chips" or the monthly service for the local supermarket.

The bank reconciliations have been made or checked and other routine cash functions have been initialed off on the program

During the course of the financial audit of cash, the CPA or staff man has conscientiously considered all of the internal control aspects of cash handling and safeguarding. He may have promptly noted that independent listings of incoming cash receipts are not made for subsequent comparison to the cashier's deposit slips, or he may have immediately noted that supporting data are not being effectively cancelled.

All this is a matter of training and a normal state of mind which accounts for the quick discovery of this internal control deficiency. But, through an extension of this state of mind to further evaluation of the "control" of cash—merely by continuing to search within another portion of the established definition of internal control—*"to promote operational efficiency and encourage adherence to prescribed managerial policies"*—much more can be done.

If it is second nature, even to a junior accountant, to automatically consider whether the key to the check signer is under strict control, as well as the other elements affecting the financial control of cash, then is it not logically second nature to ask further questions about *management control* of cash? For example:

1. Do the management controls of cash include a system of cash forecasting?

2. What control is exerted over the potential for investment of excess funds?

3. What controls, too, are in effect to properly plan that requisite funds shall be on hand to meet the business needs?

4. Are cash reports in use? If so, are they adequate, or is a better system of reporting needed?

It will be argued by some readers that management pays continual attention to cash position, and that a CPA will rarely locate an opportunity to render a management service in such a basic area. There is reason to take issue with this point of view. It appears true that small business managers pay a good deal of attention to continually evaluating whether they have *enough* cash with which to operate, but it is doubtful whether a majority of them recognize when they have too much cash, or have any idea what their cash balances will be sixty days from now.

To illustrate how a small business and its CPA can benefit from a review of its cash management, consider the following excerpt from a CPA's management letter.

"During the course of our regular work, we reviewed the controls utilized to manage the company's cash. While we will be pleased to provide more details, we wish here to provide only a summarization of our findings.

"Month-end cash and outstanding loan balances during the year were as follows:

	Cash	*Loans Payable*
January 31	$17,200	$22,000
February 28	16,800	22,000
March 31	32,400	20,000
April 30	32,300	20,000
May 31	41,400	20,000
June 30	47,700	18,000
July 31	46,200	16,000
August 31	54,600	13,000
September 30	62,300	– 0 –
October 31	39,100	– 0 –
November 30	21,900	– 0 –
December 31	14,600	25,000

"As a policy of long standing, management has arranged its borrowing requirements in December and scheduled repayment to be made in installments during the first six or eight months of the year, in amounts which, in management's discretion, provided for retention of adequate cash during this period. We were informed, further, that management has never invested funds during periods of cash excesses as your commercial bank does not offer 'time deposits' nor may local savings institutions legally accept corporate accounts.

"It is our opinion that a formally established system of cash forecasting will save considerable interest cost and permit establishment of a program whereby excess cash can be invested in short-term U. S. Government obligations which will contribute substantially to profits. Detailed calculations have not been made of the saving in interest cost, or of the interest income from investment of excess cash which could have resulted from this type of program during the year, but using the foregoing schedule as a basis of quick estimate, we are confident that the contribution to profits could have exceeded $1,000. We would also like to call your attention to the possibility that time deposits in certain foreign banks, if possible to arrange through your sales subsidiaries, could result in an even higher yield and resultant contribution to profit."

In this specific case, the president of the small business engaged the CPA to install a simple cash forecasting system—a move from which both profited. It is important to mention, too, that this particular suggestion stemmed from a semi-senior accountant's work in the regular audit of cash.

Receivables. Consider next trade receivables—as common to financial audits as cash. Where might an alert CPA extend his examination to uncover management control deficiencies?

Many CPAs probably have not seen the need or desirability of reviewing credit and collection correspondence unless it was in connection with vouching a bad debt write-off. Experienced credit managers in larger businesses develop highly scientific collection systems involving letter series, tag codings for systematic follow-up of delinquent accounts, and so forth. Smaller businesses, all too often, appear content to scan the receivable ledger once a month for evidence of slow payments and to take their chances until it is next scanned. A brief review of the credit and collection system of a small business, while reviewing bad debt write-offs or aging the accounts, will often disclose control deficiencies that have contributed to losses.

Another reasonably common deficiency, found in businesses of any size, is that of *a too tight credit policy*. And yet, if it is a policy of long standing, it will probably never be challenged by anyone inside the company.

A CPA can often serve management well by reviewing the credit administration in the small business that points with pride to its consistently low ratio of bad debts to sales. The alert CPA may not only find an area of lost profits through lost sales stemming from too tight a policy, but can generally find, coupled with it, evidence of overexpenditure in credit policy administration.

Consider the company which habitually checks the outstanding balance of each account from whom small orders are received. It is doubtful that it will show less loss than a company which eliminates the time-consuming "look up" in favor of filling any order for less than, say, $100 unless the account is known to be delinquent. After all, 999 out of 1,000 of these orders are usually shipped to nondelinquent accounts anyway, whether "procrastination time" is invested or not.

Has every CPA's staff been asked or trained to note the method, if any, of customer credit classification—or do they merely flip over the ledger cards while aging without even noticing the yellow, blue or red tabs (or the lack of them)?

And why ledger cards or a receivable ledger? From habit, or perhaps because an overly control-conscious bookkeeper believes these new ideas of merely filing unpaid invoices or EDP receivable cards in open tubs are dangerous? A CPA who has stopped to question the real need for time-consuming ledger posting, compared to a controlled but simplified substitute, will have little difficulty in selling management (or the bookkeeper) on the change. Accounting procedures of this nature, particularly those which result in economies, are often those where management will turn right back to the CPA and say, "If *you* recommend the change, change it." But if the deficiency is not located and the proposal for change is not made to management, obviously the benefits cannot accrue to either party.

The foregoing are but a few examples of deficiencies in management control which can be uncovered through simple extension of the receivables audit. There are many other functional areas to which it might also extend. The order handling and billing are closely related to receivables and the gate is opened for inspection of these functions. For example, every CPA has probably been disturbed at one time or another by the length of time it took a client to ready customers' statements before audit confirmation work could start. But how many CPAs have investigated the feasibility of introducing cycle billing to these clients in order to eliminate this month-end problem?

Inventories. Returning briefly to the premise that "every president likes to talk about his inventories"—just what is it that makes them such an interesting conversation piece? Inventories—their production, purchase and sale—are directly or indirectly the heart of any business that makes or buys and sells to make a profit. The cost of acquisition or production of inventories, their salability or obsolescence—their mark up—or mark down—their flow, carrying costs, and turnover are the factors over which management control must be carefully and continually exerted if maximum profits are to be shown.

How can the financial audit of inventories lead to a review of these important management controls? Consider for just a moment how many operating areas or company functions are crossed in the conduct of the audit of inventory.

The taking of the physical inventory of a smaller business provides the opportunity for a CPA to review storage and material handling facilities, plant layout and production facilities, as well as providing him with a picture of how production flows. The pricing of inventories results in contact with the cost system, or the perpetual inventory system, with vendors' prices and the purchasing function.

The normal inspection and evaluation of obsolete or slow-moving inventories provides an opportunity for considering not only the balance sheet pricing, but also the reasons *why* it has become obsolete. An analysis of this type will often reveal deficiencies in the production planning, or purchasing, or perhaps it was created by poor organizational structure or communication which does not adequately control the co-ordinate efforts of production and sales. Better yet, try aging the inventory from perpetual inventory cards. It can often be productive. Take every tenth card, divide the balance by the last year's usage, and watch the results. In a business with poor controls, you may find everything from a ten-day to a fifty-year supply on hand—evidence, of course, that control is lacking somewhere along the line.

Analyses of cost variances, a procedure normally undertaken in the financial audit of inventories, are sometimes dismissed by CPAs as only indicative that a client's standards are "good" or "bad." Closer analysis of the variances is one of the easiest ways to uncover operational deficiencies in management controls of labor, materials, or other elements of cost.

Consider a specific case in which the first annual audit resulted in a special management services engagement for a medium-sized CPA firm in the Midwest.

Their new client, a small manufacturer of several types of metal products, had recently set up a relatively sizable division for a new wooden product. It was in the early months of full-scale production at the time. This small manufacturer's cost accounting system was a simple one, but seemingly provided adequate summaries of labor, material and overhead variances. Neither cost reports, nor the books reflected the variances by either individual products or cost centers. The senior on the job, who was inspecting the variances as part of the inventory audit, found, merely on the basis of comparison to the over-all variances of the prior year, that some strange changes had occurred—not attributable, however, to the fact that there had been some changes in standards made during the year. Analyzing further, he found that the typical trend of variances had changed a few months after the new wooden product had been in production. The client was inexperienced in actual production of this product, but was confident that selling prices, based largely on competition, were producing about a 40 per cent gross profit.

The variances had taken such a strange turn that the senior sought first to determine whether the standards for the new product were a reasonable basis for inventory pricing. He received an explanation from the cost accountant that his own conclusions, to which management had agreed, were:

1. That the material cost standard had been set too high, which accounted for the favorable variance. This variance, the senior noted, was not broken down as to usage and price factors.

2. Inexperience of the operators accounted for some of the excessive labor cost, but the unfavorable labor variance was principally attributable to setting standard times too low.

3. The overhead variance appeared unfavorable only because the standard plant rate had been applied to actual accumulated costs and, while they recognized that a separate overhead would

have to be developed after they had more experience with the operation, the plant people and management were satisfied that the higher overhead was attributable only to some nonrecurring expenses they had incurred during the first months of production.

4. The high scrap variance was attributable to the quality control standards, which were deliberately set high so that sales introduction of the product would not be hurt by a low quality of manufacture. The sales people had been properly concerned that customers might be skeptical of the company's ability to produce wood products, in spite of its long experience in metal manufacture, and that defects in the new products could quickly "cook their sales goose."

In view of these reasonable explanations, and since management apparently was confident it knew what was going on, many auditors would have considered it logical to apply the information to the financial audit problems and drop the issue. Actually, however, this senior became increasingly suspicious—partly because he had found evidence that the wood product had been thoroughly engineered and test manufactured, and also because precise specifications of manufacture had been established by a production engineering firm before full-scale production was started. Secondarily, the cost system did not satisfy him. It did not provide for usage and price variances. Scrap loss included the cost of material only. No information was available in respect of labor loss, or rework cost on scrap work, or other factors which enable an accurate evaluation of the reasons for scrap. The overhead allocations appeared arbitrary and, under the existing system, true overhead cost in this new "cost center" could not be determined.

Discussion between the senior and the partner in charge left both of them with the impression that their client was actually flying blind in its new venture. The partner discussed "inventories" with the president and, of course, found a receptive and alarmed ear to his belief that there was a good deal of management information to be desired in really figuring out the cost to manufacture the new products and the reasons why they were running so high. The partner was asked to state in writing his conclusions as to the basic deficiencies.

His letter was specific as to the deficiencies noted in the foregoing paragraphs. Further, it pointed to some of the possibilities for generation of the high cost which the present cost system would not point up. A further check of practices in this department had disclosed deficiencies in time reporting for the production of this product. It had disclosed, too, the lack of proper reporting of scrap and rework by inspectors and quality control people. His letter, of course, could not attempt to answer the questions. It could only point to the specific deficiencies and problems he and the senior had seen.

Even before the firm was engaged to revise the cost accounting system, the production manager, to whom the partner had been asked to send a copy of the letter, had reviewed his material specifications with the purchasing agent and cost accountant. A further analysis of the material variance, to determine price and usage, had been suggested in the letter and it had revealed that purchase price variances had been favorable indeed—so favorable that further investigation revealed that an inferior grade of lumber was being purchased. The lumber supplier had apparently convinced the purchasing agent that the company could save money by purchasing an "almost identical" product in carload lots on a drop shipment basis from a mill. The company did save money, and receiving department personnel and inspectors, just as the lumber salesman had said, were unable to tell the difference in the lumber. They were, of course, inexperienced with wood and wood products.

In the course of the special work for which the certified public accounting firm was engaged, a reconstruction of the available cost records proved indisputably that raw material cost, as well as labor and scrap costs, was greatly in excess of planned cost because of the high scrap and rework factor resulting from the poor grade of lumber.

Action by the client, as a result of a CPA simply extending his financial audit and subsequently rendering a separate special service, went beyond adopting a revised costing system. The CPA's findings resulted in management attention to this operation which within sixty days had:

1. Changed purchasing specifications twice more to improve

quality and processing, and had adopted new quality control specifications and reports.

2. Reinstated the use of multiple jigs that, due to the poor grade of lumber, had been abandoned when they did not work properly. This increased machine capacity and output significantly.

3. Changed the plant layout to provide a continuous work flow which costing procedures and revised time reporting methods, particularly of idle time, had indicated to be poor.

4. Dropped five high cost, low turn items from the new line.

In summary, what had started as a routine review of cost variances turned into assistance to management in not only overhauling the cost accounting and reporting system but improving the manufacturing operation as well. The client now appears headed toward a desirable gross profit level on its new line. The CPA firm is equally sure it is headed toward other special engagements with this client.

Other areas of audit. Cash, accounts receivable and inventories have received brief coverage for purposes of illustrating that even the most common areas of audit can be the entrance to management service engagements. If other common areas of financial audit were discussed, similar entrances could be found. Extensions of the audit of fixed assets, for example, may logically range from such relatively simple evaluations as those relating to the adequacy of property ledgers and depreciation or disposal policies all the way up to the more intricate evaluations of management control over make, buy or rent decisions. The audit of sales can just as easily lead to review of pricing policies, the order handling function, shipping, distribution or warehousing policies, sales reports or statistics. Payroll audits provide opportunity for inspection of management policies in respect of incentive systems, labor standards, work measurement, fringe benefits and other personnel practices.

It is hoped that the foregoing discussion has illustrated to readers that there are many areas within the competence of each CPA where opportunities exist to render additional services to small business clients.

The best use of staff, tools and techniques

LET US RETURN NOW to the resources which, if adopted, can help a CPA or firm to perform a better review of management controls. They are:

1. The staff
2. Management control questionnaires
3. Management control audit programs
4. Industry operating ratios and statistics
5. Management letters

This section of the bulletin will describe briefly the most successful techniques of others experienced in the use of these resources.

The staff. It is here that the factor of maturity is important. Experience has rightly been called the best teacher, and while a partner or practitioner with many years of experience can call upon all of this experience in reviewing management controls, the less experienced staff man cannot. This obviously creates a problem, for in typical engagements it is the staff man that is generally closest to most of the operational areas through, for example, the audit of cash, accounts receivable and inventories. For this reason, most firms that are seriously seeking to expand their services are making formal efforts to orient their audit staffs in the techniques of reviewing management controls.

State of mind and technical ability are the factors that will determine how valuably a staff member will perform, and the answer to both of these factors lies in training. The experience of others dictates that there are four proven methods of staff training.

1. Encouragement for *self-improvement,* principally through library resources and study of reference material. As in any other area of practice, appropriate reference material is a must for a firm expecting to practice management services.

2. *Staff training programs* within the firms, conducted by a principal or other person who has the appropriate qualifications

for organizing and leading a specific educational program of this type. Experience dictates that "staff bull sessions," unless headed by one with appropriate qualifications, will often result only in "the blind leading the blind."

Furthermore, such sessions must be well organized and specific as to coverage. They must also be geared to the level of the capacity of the individual staff members. Few firms, if any, have met success in attempting to make management services specialists of their audit staffs from this type of training alone. Therefore, there seems to be nothing gained by concentrating, for example, a four-hour, semi-senior staff training session on how to install a wage incentive system in a plant. It has proved preferable to make a group of this level conscious of the types of wage incentive systems and their advantages, so that the acquired consciousness can result in an automatic appraisal of the client's system when they next audit payrolls. But as a "semi" advances to senior, and then to supervisor, this early staff training, supplemented continuously on each staff level as he progresses, logically results in the development of a man far better qualified in reviewing management controls than he otherwise would have been.

Audit staff men who are particularly receptive to this type of training and interested in this type of work can ultimately become the firm's management services specialists. For many years, the larger CPA firms with well-organized separate management services departments had almost always gone outside their firms to recruit the consulting talent they required. More recently, however, many additions to their management services staffs have been recruited from their own audit staffs—in cases, of course, where staff men have demonstrated both potential and interest. There is distinct evidence that the audit staff is becoming an increasing source of talent all the time, which leads to the conclusion that management services training programs are paying off.

Included in this bulletin (p. 69) is the written policy of one large firm which describes the qualifications desired of a management services staff man. The CPA firm that would like to start staff training programs, with a view to assisting in the eventual development of some of its audit staff to management services specialists, could do well to design its own training program so that these desirable qualifications may be imparted in each staff man's training. Reference to them may also help a firm in deciding whether to step up or reduce training in cases of specific audit staff men.

3. The third method of developing a staff man into a better management services man involves *special courses.* Firm-sponsored attendance at study courses or seminars dealing with management services subjects will not only help the staff man in developing a management state of mind, but will generally provide more educational value in specific techniques of management services practice than firm-conducted staff training sessions. Excellent examples of valuable course offerings are, of course, those of the American Institute's Professional Development Division. A seminar on "Budgeting for Profit in Small Business" is already available and the future promises others dealing with management services subjects.

4. Some CPAs believe that *on-the-job training* is the most valuable method of inculcating the idea of reviewing management controls among staff men and training them for it. Some firms practice it as a regular function. Others have experimented with it and have found it valuable, although somewhat time consuming. In the medium and large-sized firms, it has generally involved sending a management services specialist to the client's office near the end of the engagement to review in more detail the management control deficiencies that have seemingly been located by everyone on the job from the junior to the partner in charge of the engagement. The specialist reviews the internal control questionnaires, the management services questionnaires, and the results of any management control audit programs that may have been used. He assists the staff in evaluating the severity of the deficiencies they think they have uncovered—he challenges those that the staff may have felt to be insignificant findings for the assurance that they are in fact insignificant and not clues to deficiencies worthy of management attention. He helps in drafting portions of the management letter. But more

important, perhaps, he is providing on-the-job training to the audit staff. As he challenges, aids, expands, explains, the staff learns and they carry this experience to their next assignments.

In some cases, incidentally, the time spent by the specialist is charged as audit time and is billed as such. A client rarely objects if it is understood that this is a normal review of basic internal and administrative controls which form a part of the regular work. One pitfall to watch for here, however, is that, if great fanfare heralds the arrival of a "management expert," the client may erroneously gain the impression that his entire operation is to be "business surveyed." If a deficiency should be located later, either in a subsequent audit or by management itself, it can sometimes be difficult to explain why the "expert" could not have discovered this deficiency. So, depending largely on the nature of the engagement, a certain amount of caution is in order, in case the client misunderstands the true nature of the process and the benefits that can normally be expected to accrue to him.

Another type of on-the-job training in management services work involves taking a few of the best men (generally semi-seniors) from the audit staff and assigning them as assistants in the management services department for periods of three or four consecutive months in order to provide a concentrated training. This is currently being practiced by both large and small CPA firms that have established management services departments. They have not found this to be a dead loss in salary cost. On the contrary, it has been a profitable move, for in every case they have successfully found more than enough chargeable time on management services engagements for these assistants and a corollary advantage has resulted—it has permitted those firms with few specialists to broaden their activities by turning over much of the detail to these assistants. After their training period, the men are returned to the audit staff, but they return again for a similar stint the following year if they have demonstrated interest and potential for management services work. After trainees have satisfied the experience requirements for the CPA exam, they are transferred as permanent additions to the management services staff.

One firm that is now experiencing excellent results with this type of program had abandoned a similar one a few years ago. Using hindsight, they can point to several reasons why the original program was a failure. Among the more significant were:

1. They did not really concentrate on training the men. This was the original intention, but they immersed the trainees in detail on engagements, did not program their work carefully, and did not provide close supervision. In short, they made the mistake of utilizing the trainees like experienced management services men in all respects except level of work. Result—the trainees learned little, lost interest and, since they were making progress on the audit staff, preferred to leave well enough alone when they were asked if they were sufficiently interested in returning for more "training."

2. Another mistake was that their selection of the audit staff generally occurred only at, and for, times when help was badly needed. This precluded a concentration of training for an extended period and, more particularly, a concentration of training in one area, such as cost accounting, for example. Furthermore, obtaining men from the "bullpen" resulted more often than not in selecting staff men who were not interested or who did not have the best basic qualifications for management services work.

This firm has corrected its own controls over its on-the-job management services training program and is now getting excellent results.

The staff can be the key to the extension of the regular work to the review of management controls. Training will require a certain investment of time and money, but based on the experience of others, it is worthwhile for any firm that wishes to render this valuable service to management and expand its own practice.

The management control audit program. The management control audit program is basically an extension of the management control (or management services) questionnaire. Research discloses that a few CPA firms utilize audit programs, but not nearly as extensively as questionnaires. For the CPA who feels particularly well qualified to make an extensive investigation of one or more phases of clients' operations, they can be extremely valuable. Their use ordinarily requires that the "user" be more experienced and knowledgeable in the area under review than is required in the use of the questionnaire. For example, a questionnaire prepared for use of the audit staff when inspecting for basic deficiencies in management control over the purchasing function might be limited to the following key questions:

1. Who, in general, may initiate purchase requisitions?

2. Is there evidence that adequate procurement control is concentrated in the purchasing department?

3. Is there evidence of too much concentration of control, which results in production delays or other inefficiencies?

4. Is competitive bidding a continual practice?

5. Is there evidence that purchases are made from budgets, production schedules and/or automatic reorder points in formalized economic lots?

6. Do purchasing department files and records appear adequate?

The answers to these six questions alone will reveal the more significant violations of good administration of purchasing in a small business. More important, perhaps, is the fact that the questions can be adequately evaluated and answered by any staff man who has experienced the benefit of even brief orientation into the principal elements of proper management control of the purchasing function.

The management control audit program goes much deeper. Consider the following program developed for the use of the auditor more thoroughly grounded in purchasing techniques and administration. This program, used with appropriate investment of time and by a staff man qualified to delve this deeply, is more apt to point up trouble spots, although perhaps less significant in some cases than the more limited questionnaire.

1. Investigate the incidence of competitive bidding.

2. Investigate the incidence of formalized material specifications.

3. Investigate the concentration of buying within the purchasing department.

4. Investigate directed sources of supply.

5. Investigate follow-up of orders placed.

6. Determine the basis and formality of "make" or "buy" decisions.

7. Determine degree of concentration of buying in limited vendor sources.

8. Determine if economic lot buying is practiced. Describe basis.

9. Determine if advance notice of annual production program is given to and utilized by purchasing. Investigate for adequacy the degree of co-ordination established with production scheduling function.

10. Investigate system of automatic supply reorder points.

11. Investigate handling of routing instructions, shipment and discount terms.

12. Determine if vendor financial stability is periodically checked.

13. Investigate purchasing files for adequacy.

14. Investigate for price discrepancies—invoices to purchase orders.

15. Determine if technical tests are made of materials when vendors are changed.

16. Investigate procedures in effect for procurement of "trouble items"—special tooling, dies and jigs, use of outside vendors for various services, including design services, etc.

The foregoing program could be expanded even further, but this illustrates the potential of the formal audit program. Is the use of such a formidable program necessary in the audit of the purchasing activity of a small business? Probably not, but for those CPAs who feel particularly well qualified in a special area of a business or who feel that additional benefits could be obtained from the development and their use for all areas of a business, it is hoped that the foregoing serves as a helpful illustration of how they might be prepared and utilized.

Industry operating ratios and statistics. One of the most valuable tools of the review of the management controls of the small business is the use of operating ratios and statistics. Comparison of a client's operations to similar businesses within the same industry can often provide the principal clues to deficient controls. With the knowledge that a cost relationship or some other aspect of the business is "out-of-line," a more intensive investigation into the areas which could account for or create the "out-of-line" condition will logically follow and will often be fruitful. The review of management controls is bound to be more productive if the CPA can develop clues as to where to look especially hard.

Trade statistics and operating ratio analyses are usually available from the industry's trade associations or from Dun & Bradstreet, Robert Morris Associates, U. S. Federal Trade Commission, and so on. Included in the appendix of this bulletin is a relatively comprehensive list of trade associations and other sources of such information.

The management control questionnaire. Probably the most valuable tool in extending the regular work is a questionnaire designed to assure that review is made of the areas which are most often troublesome. A good questionnaire can keep the staff man on the right track, confine his activity to key areas, curb "witch hunting," and control the expenditure of the staff time. The latter, particularly, can become a real practical problem if checks are not placed on ambitious staff men who, erroneously believing that they have been granted a "hunting license," wish to demonstrate their prowess in "management consulting" at the possible expense of the regular work.

The use of questionnaires in the review of management controls is relatively new, but among most firms that have adopted them, their use is growing rapidly. Some firms say they have been extremely productive—others have not yet experienced the same results. In almost all cases where they are used, they are used in conjunction with the internal control questionnaire.

Research discloses that a diversity of opinion exists as to content, extent, and form of the questionnaire. One firm, that has one of the largest management services divisions in the profession, for example, uses a short—two page—about twenty-five key question form that basically requires only "Yes" or "No" answers. It is their contention that proper follow-up by the audit partner in charge, or a specialist, eliminates the need for the staff man to go beyond locating the basic trouble areas. Others then take it from there; and through the wider experience of the partner or specialist a better and less time-consuming appraisal of the full nature and extent of the control deficiency is believed to result.

Another large firm, equally well organized in its management services division, uses a more extensive questionnaire, and feels this produces better results. It consists of seventeen pages, and about 100 questions or reminders of inquiry. Furthermore, it requires subjective answers rather than just "Yes" or "No." Two of the more subjective questions included ask, for example:

1. Are there any data on use of available capacity, productivity trends, inventory accumulations and so on, that might indicate special problems in production? Explain.

2. Is there a balance between production facilities and market available? Explain recent relationship in this regard.

The questionnaire used by the first firm does not ask the staff man to make explanations, let alone seek or provide answers to questions of this magnitude. Does this mean one firm is right, another wrong? Not at all, for in each of the cases they have prepared a questionnaire for use under a different modus operandi. This leads to the point of this discussion—each firm, in developing a questionnaire must develop it in consideration of:

1. The level of training, experience and competence of the staff who will initially utilize the questionnaire, as well as the partner who will review and follow up the questionnaire. The answer to this question will obviously have a significant influence on the type of questionnaire to be employed, as well as the depth of its search.

2. What is the size of the typical client served? This, too,

must be considered—for the necessity of seeking out signs of nepotism in a small business run by father and son is hardly as practical as seeking for it in a large publicly held corporation—and conversely, where it would be desirable for the CPA to determine by questionnaire if the owner/managers of a small business have wills, and their estates planned, it is certainly not within the scope of the review of management controls for a CPA firm to be asking the officials of a publicly held corporation questions about their personal affairs.

The foregoing points may have been oversimplified, but only to emphasize that each firm must adopt and utilize a questionnaire which can do the best job for it and its particular clientele.

Included in an appendix are three management control questionnaires which vary in approach as well as scope. Additionally, a short questionnaire appears in Bulletin No. 13 of the Economics of Accounting Practice series. The utilization of all of these as guides should enable a CPA or firm to gain enough information and ideas with which to prepare a questionnaire best suited to its own purpose.

The management letter. A vital step in the review of management controls is the report to management of the deficiencies noted. As previously stated, there is considerable evidence that there is much small business management counseling, primarily in the form of valuable informal conferences following the regular work ("hand holding" some call it), but there is also considerable evidence that this type of reporting can leave much to be desired for both parties.

Management is often less inclined to seriously consider or to take action on deficiencies or recommendations made on an informal basis. Further, there is always so much to talk about that the results of the review of management controls are often obscured in favor of the financial audit or other regular work. What is the final profit? How much tax do we owe? What is the nature of the audit adjustments? Should a dividend or bonus be declared? Questions of this type are most often the first questions management wants to discuss thoroughly, for that is why the CPA was engaged in the first place. Most CPAs will probably agree that the busy owner or chief executive of a small business often does not have time or may not be receptive to pursue other matters at that time. Some CPAs may disagree with this, but it is the experience of those who have discarded this approach, in favor of reporting the deficiencies and recommendations in a separate package, that greater benefits are attainable.

A word of caution is necessary in case the inference should be drawn that no mention should be made of management control deficiencies during the usual informal conferences. It is well, at least briefly, to inform management of what is intended to be submitted in writing, for this discussion can prevent a CPA from eliciting management reactions to points in the letter such as:

"Don't they know we tried this four years ago with very poor success?" or

"Our internal auditor has been studying that problem for the last six months," or

"Don't they know that this is prohibited to us by our union (or by state law regulating our industry, or by contract with our supplier, or by something or somebody else)?"

With the control deficiencies once mentioned and acknowledged by management as worthy of attention, consider the following advantages of the supplemental management letter.

1. It provides further opportunity for the CPA to give independent thought to the management control problems, thereby enabling him to render a well-thought-out and complete presentation. By so providing, it can eliminate the possibility of a management believing, on the basis of an improper solution offered too quickly, that the "CPA's figures are right, but, as usual, his conclusions are wrong." It provides opportunity, too, to continue calling attention to deficiencies noted in previous letters. Management action may not be taken on the basis of the first notification, but often will be the second or third time the CPA mentions the weaknesses.

2. It provides management with the opportunity of reviewing the deficiencies independently of other matters. Experience dictates that the informal luncheon conversation, in which the small business owner-manager heartily agrees that he should and will take action on the CPA's proposal that a budget system be introduced, is often forgotten. The same proposal, if made formally

in writing, is more likely to result in action, and further, it is the vehicle by which the proposal can be called to the attention of others in the organization—either by enclosing additional copies for distribution or by sending copies directly to other executives who should be interested. In this way, the letter is more likely to receive action or provide the basis of formal discussion at the next executive or board meeting.

3. Reporting deficiencies in writing permits the accent to be initially directed at *the problem,* rather than the answer. Proper solutions are rarely found until the true nature of the problem and all the facts surrounding it are thoroughly known. Informal reporting of deficiencies too often leads to an impulse to seek quick remedies which ultimately prove to be either improper, or stop-gap, at best. This practice will not be as valuable to a client as would a carefully programmed study of the problem and the separate rendering of the proper solution. From the CPA's viewpoint, initial concentration on the problem permits, in turn, separate concentration on a proposal to management for correction of the problem. In other words, full exploration of the problem makes the CPA's task of programming the corrective work to crystallized, specific goals and limitations of the engagement, as well as the fee to be charged, that much easier. Some CPAs find it difficult to submit a specific work program as well as a definite estimate of the fee for a management services engagement. In most of these cases, *the difficulty stems from the fact that the problem itself has not been adequately researched and defined, and agreement reached with management as to what is specifically needed to solve it.*

4. Reporting separately and in writing on management problems permits the CPA to better appeal to the "profit motive" and in so doing will enhance the so-called "image" of the CPA. A president or owner will find the letter to be distinct evidence of the fact that the CPA has identified himself with management's objective of profitability. Further, the separate report can provide an opportunity for client contact at a date after completion of the regular work, with resultant good will.

5. An important benefit to the CPA lies in the separation of

the regular work and management services work as it respects staffing with his own personnel, as well as gaining the assistance of client personnel who are generally tied up during the course of regular work. The solution to a problem is often the result of a joint or pooled effort of several of the client's personnel, the CPA, his staff, and perhaps some other outside consultant. As a result, the smaller firms or practitioners in particular, with the pressure of many calendar year closings and attendant tax deadlines, will find the separation of services especially advantageous. It, of course, also permits separation of time for billing purposes so that the client and the CPA each know better where they stand.

6. It formally puts the CPA on record and as such becomes a defense mechanism should a client suddenly "discover" the same need for improvement.

A sample of a management letter written to a small business client by a small CPA firm is presented later in this bulletin (p. 60). This particular letter reports on management control deficiencies in nine different areas. Some practitioners believe that several letters, covering only a few areas in each, are more effective. Management letters do not lend themselves to standardization, nor can there be any pattern of uniformity. Each engagement has its own problems and the CPA firm must determine what should go into each letter and how it should be presented.

Summary

For the firm that wishes to expand its services to management, extension of the regular work to the review of management controls can be the key. The continuous practice of this function will permit the CPA to gradually expand his activities to include management services increasingly distant from the traditional accounting function. The additional knowledge and experience gained by the CPA and his staff in initial engagements derived through a review of management controls will lead to expanding accomplishment in the future. And, as each CPA, as well as the profession as a whole, expands the scope of services, increasing benefit will result for the small businesses of the country.

ILLUSTRATIONS OF QUESTIONNAIRES CURRENTLY IN USE BY CPAS FOR THE REVIEW OF MANAGEMENT CONTROLS

As POINTED OUT in the preceding part of this bulletin, practices in the use of questionnaires vary from firm to firm. The reasons for this are explained on page 36.

Space in this bulletin permits publication of only portions of the various types of questionnaires, and for that reason, certain elements of duplication within the different types have been eliminated. The portions used for illustration have been selected (or carefully reworded in some cases) so that a reader, after reviewing all of the questionnaires illustrated, may: (1) obtain the best coverage of the most areas into which his firm might extend its services, and (2) develop the type of questionnaire best suited to his particular needs.

The first to be illustrated (pages 43 to 45) is an abbreviated type designed principally for use by the nonspecialist staff man. While it will valuably direct the staff man's thinking, it is restrictive in its search to those areas in which staff men are familiar or in which they may quickly be trained. The questionnaire calls primarily for "Yes" or "No" answers only, and as such, does not require the expenditure of excessive staff time during the course of the regular work. In practical usage, the staff man is permitted (and requested) to make brief comments, qualifications, or suggestions to supplement his "Yes" or "No" answers. In all cases, either the partner-in-charge or a firm specialist reviews the questionnaire and actually makes, or has the staff man make, further investigation where it appears necessary. The partner or specialist also evaluates the significance of noted deficiencies, and if and how they should be brought to the attention of management.

QUESTIONNAIRE FOR REVIEW OF MANAGEMENT CONTROLS

Client ______________________________

Prepared by ______________________________

Date ______________________________

Yes *No*

I. **Organization**

(a) Are organization charts in use?

(b) Are they up to date?

(c) Are management policy and operating procedure manuals in use?

(d) Are job descriptions prepared and used?

II. **Budgets**

(a) Is a formal budget system used?

(b) Does it include:

(1) All divisions and departments?

(2) Forecasting of cash and budgeting of capital expenditures?

(3) Timely comparisons to actual results?

III. **Office Management**

(a) Does office layout provide for efficient work flow?

(b) Is a good system of forms control in effect?

(c) Is there an office manual?

(d) Does the company have a written records retention program?

(e) Has a clerical work measurement program been introduced?

Yes No

(f) Does the office machinery appear to be the best for the job?

IV. **Data Processing**

(a) Does it appear that data processing applications could be used?

(b) If in use, does maximum utilization appear to be effected?

(c) Is the system well organized and programmed? Do results appear to justify costs?

V. **Management Reports**

(a) Are internal reports to management issued quickly and timely?

(b) Are there apparent duplications in reports?

(c) Is "responsibility reporting" in effect?

(d) Is "management by exception" a company practice and are reports prepared on this basis?

VI. **Cost Accounting**

(a) Is a cost accounting system used?

(b) Does it provide for performance measurement?

(c) Does it tie into the general ledger?

(d) Are standards and overhead rates up to date?

(e) Have the cost centers been properly established?

(f) Are cost variances analyzed and reported? (as to price, usage, etc.)

(g) Does system provide adequate information for compilation of break-even data and analysis of profit-volume relationship?

	Yes	No
VII. General Accounting		
(a) Are accounting manuals used?		
(b) Does the chart of accounts provide for the accumulation of adequate financial and cost information?		
(c) Are "fast closing" techniques utilized?		
VIII. Personnel Practices		
(a) Do personnel practices include:		
(1) A formal selection process including a testing program?		
(2) A job classification and evaluation program?		
(3) A training program (including management development)?		
(4) An employee handbook or manual?		
(5) Proper personnel department reporting practices?		
(6) Wage incentive systems for:		
(A) Sales personnel?		
(B) Factory personnel?		
(C) Office personnel?		
(D) Supervisory personnel?		

Comments (Reference comments to appropriate question number and letter above. Include on a separate workpaper brief comments on other deficiencies you have found, or believe to exist, in areas not covered by this questionnaire.)

(A full page is provided in the questionnaire for comments.)

The second type of questionnaire found to be in use is one that goes considerably beyond the scope of the simple "Yes" or "No" type described. It requires (1) that it be used by experienced staff or specialists and (2) that considerable time be devoted to it. The information called for in this questionnaire can often be obtained by an experienced audit staff man, and then reviewed by the partner or specialist. This type of questionnaire was developed by a smaller CPA firm that has been asked on several occasions to "survey" the principal operations and management controls of small businesses.

The reader will note that this questionnaire is almost a detailed program of examination for the particular area under review. Time obviously would not permit it to be employed in the course of the regular work. This questionnaire has been developed principally on the basis of a survey check-list included in Clinton W. Bennett's book, *Standard Costs*. The portions reproduced here are not all-inclusive as to scope—nor are they applicable, of course, to all types of businesses.

Name of Company______________________________

Prepared by__________________________________

Date____

A. **General Information (List):**
    1. Plants, offices and warehouses
    2. Organization data:
        a. Type of organization
        b. Date founded
        c. Control
        d. History
        e. Kind of business
        f. Position in the industry
        g. Growing or declining
        h. Other
    3. Business:
        a. Nature of products
        b. Diversity
        c. Volume of sales of each

4. Executive personnel:
    a. Name
    b. Title
    c. Job
    d. Lines of authority and responsibility
5. Obtain copy of organization chart from client or prepare
6. Obtain copies of most recent financial statements
7. Obtain copies of all types of management reports
8. Remarks

B. **Financial and Accounting:**
1. Describe nature of financial policies
2. Describe nature of accounting and control policies
3. List departments and show for each:
    a. Function
    b. Names of persons in charge and assistants
    c. Names and jobs of all employees
    d. To whom each person reports
    e. Hours worked per week
    f. Methods of wage payment
    g. How time is recorded and reported
4. Obtain chart of accounts
5. List books of account
6. Describe general accounting procedures
7. Describe cost accounting procedures
8. Obtain copies of all forms and show for each:
    a. Function
    b. Who uses it
    c. Dispositions
    d. Who controls it
    e. How many are used
9. Remarks

C. **Sales:**
1. Describe sales policies
2. Name and title of person in charge of sales
3. Names and titles of sales assistants

4. Territories where sold, how and how much:
    a. Own salesmen
    b. Jobbers
    c. Mail order
    d. House-to-house
    e. Other
5. Salesmen, show for each:
    a. Name
    b. Address
    c. How compensated
    d. Specialty (if any)
6. Sales office, show for each:
    a. Location
    b. Number of employees
    c. Salaries and jobs
7. List points away from the plant at which inventories are carried and show quantities at each one
8. Describe how inventories are handled and controlled
9. Remarks

D. **The Order System:**

Describe the phases of the order system cycle for *Purchase, Customer, Production, Shipping* and show for each:

1. Procedure followed
2. Records kept:
    a. Manual
    b. Mechanical
3. Reports prepared; when and for whom
4. Name of person in charge
5. Names and duties of all other employees
6. Method of wage payment
7. Hours worked each week
8. To whom all personnel report
9. Remarks

E. **Receiving:**

1. List receiving locations
2. For each location show:

a. Classes of goods received
b. Reasons for each location and quantities received

3. Investigate whether the receiving stations are:
   a. Centrally located
   b. Provided with adequate space
   c. Properly staffed
4. Describe how goods are transported:
   a. Freight
   b. Express
   c. Truck
      1. Common carrier
      2. Hired
      3. Owned
5. Describe how receiving is recorded and reporting handled
6. Describe how, where and when goods are delivered from receiving department
7. Describe how incoming goods are checked for:
   a. Quantity
   b. Condition
   c. Over, short, and damaged goods
   d. Partial shipments
8. List number of employees, names and to whom they report
9. Remarks

F. **Stores—Raw Materials: Work-in-Process: Finished Goods:**

1. List stock rooms maintained and show:
   a. Location
   b. Classes and quantities of goods kept in each
2. Investigate whether stock rooms are kept locked and list who has access to stock rooms
3. Investigate whether the stock rooms are:
   a. Properly located
   b. Adequate in size
   c. Efficiently maintained
4. Describe handling and storing devices used
5. Describe how goods are:

a. Segregated
b. Marked for identification
6. Show quantities on hand at each location
7. Indicate records maintained
8. Describe how obsolete or surplus goods are handled and reported
9. Describe reports made, and where they are sent
10. Describe how returnable containers are controlled
11. Show name of person in charge and to whom he reports
12. Show names of other employees and to whom they report
13. Remarks

G. **Manufacturing Department:**
Make a list of departments in the order of work flow and for each department show:
1. Name of department
2. Brief description of functions
3. List of principal operations performed
4. List of machines by major classes
5. Name of foreman
6. Number of workers:
   a. Direct
   b. Indirect
7. Names of assistants and all supervisors and clerks
8. Hours worked per week
9. How time is reported
10. Method of wage payment
11. How goods are moved into, through and out of the department
12. Authority for starting work
13. How production is planned and controlled
14. How, when, and to whom production is reported
15. What is the maintenance policy
16. Who cleans up and when
   a. Machines
   b. Department
17. Daily reports made to management of machine utiliza-

tion showing:
    a. Operating time
    b. Idle time
    c. Down for repairs
    d. Down for other reasons
18. Materials or supplies stored in the department, who is responsible for them and how controlled
19. Describe inspection procedure
20. Describe how rejected work is handled and reported
21. Describe department layout
22. Describe paper work showing:
    a. Records maintained
    b. Reports prepared; to whom sent and when
23. To whom employees report:
    a. Foreman
    b. Other employees
24. Remarks

H. **Packing Department:**

Describe functions of the department showing:

1. Name of person in charge and to whom he reports
2. Names and jobs of other employees and to whom they report
3. Location of the department
4. Authority for performing work
5. What records are kept
6. What reports are made; to whom, and when
7. What classes of materials and supplies are used
8. How they are obtained
9. The method of wage payment
10. Who delivers work to the department
11. When work is delivered, and by whom
12. Remarks

I. **Shipping Department:**

Describe functions of the department showing:

1. How many employees; their duties; how they are paid and to whom they report

2. How work is delivered to the department
3. What materials and supplies are used, and how they are obtained
4. How shipments are made
5. How partial shipments are handled
6. Internal control procedures as to finished stores, packing and shipping
7. Source and extent of shipping instructions
8. What records are kept
9. What reports are made; when and to whom
10. Remarks

J. **Service or Nonproduction Departments:**

Make a list of all service and nonproduction departments and for each one show:

1. Name of department
2. Brief description of function and policy governing department
3. Location
4. Person in charge; title and to whom he reports
5. Names and jobs of all employees and to whom they report
6. Hours worked per week
7. Methods of wage payment
8. How time is reported
9. Authority for starting work
10. Materials or supplies stored in the department, who is responsible, how controlled, how materials and supplies are obtained
11. What records are kept
12. What reports are prepared; to whom sent, and when
13. Remarks
14. List all plant services, including cost:
    a. Steam plant
    b. Power plant
    c. Light and power (if purchased)
    d. Motor trucks
    e. Other

The last illustration of questionnaires found to be presently in use lies between the two already presented in respect of both scope and intensity. It utilizes the approaches of both types in many respects. In other words, it is built basically on the simple "Yes" or "No" approach, but it also requires a deeper study of areas, and some degree of subjectivity and opinion, on the part of the user. Its use, therefore, requires that the man completing the questionnaire be an experienced audit staff man who has received additional training in reviewing management controls and using the questionnaire. The partner or a specialist, of course, reviews the results with the staff man.

The entire questionnaire cannot be reproduced here. The following portions are intended only to illustrate the approach taken in this type and to supplement the areas of inspection covered in the other questionnaires. A CPA or firm wishing to prepare its own questionnaire should find it possible to develop a reasonably complete questionnaire patterned to its individual needs by enlarging on the following and through reference to the areas "questioned" in the first two questionnaires presented.

In practice, the questions or instructions are placed on the left side of sheets, with the right half left blank for answers and/or comments. To save bulletin space, the format of the questionnaire has been changed.

Name of Company____________________________
Prepared by________________________________
Date______________________________________

General Data:

1. Ownership and organization
   (a) Obtain organization chart or charts
   (b) Describe evidence of nepotism
   (c) List people (and titles) who make executive decisions
   (d) List large stockholders that are active in the business
2. Products and competition
   Describe (provide statistics where applicable and possible):

(a) Main product lines or products
(b) Main customers, geographical areas served and share of market obtained
(c) Marketing plan of company and competition—list principal competitors
(d) How does net income compare with industry statistics?

3. Review of past operations
   (a) Evidence of trends in:
      (1) Sales?
      (2) Expenses?
      (3) Working capital, or its elements?
      (4) Number of employees?
   (b) If *yes,* explain possible reasons for condition

Production Facilities and Practices:

1. Purchasing
   (a) Who initiates requisitions for raw materials to be purchased?
   (b) On what basis are order quantities determined?
      (1) Budgets?
      (2) Economic lot sizes?
      (3) Other? Explain
   (c) Is competitive bidding practiced?
   (d) Are components manufactured? If yes, is there an adequate basis for arriving at make or buy decisions?
   (e) Do inventories or the production processes disclose problems of:
      (1) Excesses?
      (2) Shortages?
      (3) Obsolescence?
   (f) Is all purchasing, including parts and supplies, done by purchasing department?
      If not, describe.
      (1) Is purchase by others subject to control by central purchasing?
      (2) Is there evidence of costly over-control?

2. Use of production standards
    (a) Are standards in use?
    (b) When were they last revised?
        (1) On basis of time and method studies?
        (2) On basis of engineering estimates?
        (3) On basis of other cost studies?
    (c) Are they used for control of:
        (1) Direct labor?
        (2) Indirect labor?
        (3) Indirect costs?
3. Production flow and control
    (a) Is there a separate production control department?
    (b) Describe briefly the production control system used
    (c) Does this system provide:
        (1) A definite procedure for determining size of economic product lots or runs?
        (2) For co-ordination of raw materials and parts throughout the entire production cycle?
        (3) For controlling inventory levels?
        (4) For scheduling of *all* production?
        (5) For usage of most economical labor loads and plant capacity?
        (6) Briefly describe records maintained, including unfilled order data
4. Production cost accounting
    (a) Is a cost accounting system used?
    (b) Describe type (process, job)
    (c) Based on standards?
    (d) Describe overhead allocation system
    (e) Is cost center approach used?
    (f) Is overhead segregated as to variable and fixed?
    (g) Is a good reporting system of cost data directed to operating people?

Management Reporting:

1. Obtain copies of following internal reports:

(a) Budget analysis
(b) Financial statements
(c) Sales statistics
(d) Efficiency (plant) reports
(e) Cost reports
(f) Other important financial reports
(g) Are reports issued timely?

2. Describe extent of budget system:
    (a) Prepared by department and division heads?
    (b) Who reviews and who approves them?
    (c) How often are actual results compared?
    (d) Are budgets adequately developed so that budget analysis is meaningful?

Financial Management:

1. What has return on invested capital been for past three years?
2. What is nature of outside financing?
3. Evidence of excess funds?
4. Evidence of deficiency in long or short term funds?
5. Are cash forecasts in use?
6. Forecasts used to support requests for funds?
7. Are there peak seasonal requirements for funds?
    (a) Special lending arrangements established (credit lines)?
8. Is computation of inventory carrying-cost made?
    (a) Cost of funds tied-up considered?
    (b) Cost of storage space and handling considered?
    (c) Cost of obsolescence considered?
    (d) Is carrying-cost properly balanced for needs of
        (1) Customer service?
        (2) Economic production runs or purchase lots?
9. What is bad debt experience in last three years?
    (a) Is there a written credit policy?
    (b) What is average collection period?
    (c) Evidence of "bad blood"—credit—sales departments?

10. Describe extent of equipment and properties leased

Management Planning:

1. Have long-term forecasts been developed?
   (a) Describe briefly
   (b) Are there any major changes planned?
   (c) Are forecasts periodically measured to actual results?
   (d) Evidence that major projects have not been subjected to adequate advance planning in the past?
2. Is there a program for control of research and development expenditures?
3. Evidence of "one-man" control?
4. Evidence of "key-man" development?
5. Outsiders on Board of Directors?
6. When was the last new product introduced?
7. Who is responsible for new product development?

Industrial and Personnel Relations:

1. Is turnover excessive?
2. Are employees unionized?
   (a) Describe areas
   (b) When were last contracts signed?
   (c) Evidence of major disputes in past?
3. Employee handbooks used?
4. Are following fringe benefits offered?
   (a) Profit sharing?
   (b) Group life?
   (c) Hospitalization?
   (d) Major medical?
   (e) Pension plan?
   (f) Other?
   (g) Obtain copies of descriptive material.
5. Describe incentive systems used

Personnel Development:

1. Definite wage administration program?
2. Evidence of on- or off-the-job training or schooling?

3. How long have management and/or key personnel held positions?
   (a) President
   (b) Marketing chief
   (c) Finance chief
   (d) Production chief
   (e) Engineering chief

Orders, Billing and Receivables:

1. Attach key forms used to acknowledge sales, to authorize shipment or manufacture and to bill customers.
2. Are sales and receivables records handled
   (a) Manually?
   (b) By peg board system?
   (c) By machine? Type?
3. Are accounts receivable records maintained in
   (a) Book ledgers?
   (b) Ledger cards?
   (c) Open invoice system?
4. How are sales data analyzed for ledger entry and statistical purposes?
5. Are unfilled and back order records efficiently maintained for production and sales department use?
6. Evidence of good credit and collection follow up system?

Marketing and merchandising:

1. Briefly describe channels of distribution (number of company outlets, distributors, etc.) and how sold (number of company sales force, direct sales to customer, through independent representative)
2. Is principal basis of pricing
   (a) Competitive prices?
   (b) Cost-volume factors?
   (c) Are costs and breakeven volumes known for
      (1) Products?
      (2) Special contracts?
3. What is nature of advertising program? (media, ex-

penditure, agency used)
   (a) Is advertising budgeted and allocated?
      (1) On what basis?
4. Where are shipping points located, and which customer types and areas are serviced from each?
   (a) What is finished goods turnover?
5. Realistic sales forecasts prepared and revised regularly?
   (a) Following factors considered in preparation
      (1) Customer inventory surveys?
      (2) Industrial and economic forecasts?
6. Is there a salesman's incentive plan?
   (a) If yes, describe

Insurance:

1. When was last insurance survey made?
   (a) By whom?
2. Were coverage deficiencies noted in audit of prepaid insurance?
3. Are safety and/or preventative programs to reduce premium cost in effect?

Labor Cost Distribution and Payrolls:

1. How many employees are on the payroll?
2. How often paid?
3. What system used for preparation?
   (a) Manual?
   (b) Peg-board? Type?
   (c) Machine? Type?
4. How many hours does it require to
   (a) Record time?
   (b) Accumulate labor distribution charges?
   (c) Prepare payrolls?
5. How often are labor efficiency reports prepared for
   (a) Direct labor?
   (b) Salesmen?
   (c) Clerical?
6. Attach a list of key forms used; note who initiates and approves

AN ILLUSTRATION OF A MANAGEMENT LETTER WRITTEN BY A SMALL CPA FIRM TO A SMALL BUSINESS CLIENT

In practice, it is not likely that the management letter would include as many weaknesses as are noted in the following illustration. The inclusion of many items in this letter is intended to provide the reader with further ideas in respect of matters to which the review of management controls can extend.

January 30, 19__

Mr. W. A. Kuehn, President
Foley Company
Floral Park, No State

Dear Mr. Kuehn:

Following the preliminary examination of the accounts of the Foley Company, which we performed in October in connection with our first annual audit of your records as of December 31, you will recall that we wrote you concerning certain deficiencies we noted during the course of our review of the internal controls. We are pleased to report that action has been taken on most of our recommendations for strengthening these financial internal controls.

We now take this opportunity to bring to your attention certain observations and suggestions for improvement of the company's management controls. These controls are also internal controls but are that segment of the over-all system of internal control which deals principally with the promotion of operational efficiency and adherence to the management policies of Foley Company.

Accounting system

THE RELIANCE on accounting data, which are necessary for decision-making in any business, creates the need for a high degree of confidence in the figures and for more effective analysis of the facts and the processes relating to them. The Foley Company accounting system does not wholly contribute to these ends, for the following reasons:

1. We observed that your *chart of accounts* is basically the same as it was many years ago. However, as the company has grown, different types of operations have been undertaken, but additions have not been made to the general ledger chart of accounts to provide information we believe would be helpful to management. We believe that a new chart should be developed so as to provide, readily, data required for internal operating reports. Examples of these data are profit figures by product groups and separate overhead rates for the different operations. This matter has been discussed with your controller, who agrees that the chart of accounts should be completely revised.

2. We recommend the installation of a standard cost system, controlled by the general ledger, which will provide more informative monthly operating statements. Estimated gross profit percentages are now used to arrive at cost of sales figures for the monthly operating statements. Under this method, material misstatements have resulted and have not been detected until the year-end when the complete physical inventory was taken. Good internal and operating controls presuppose an adequate system for the determination of the cost of goods produced. It follows then that the cost system should be tied in with the general books. It is suggested, therefore, that management consideration be given to the installation of a standard cost system since this appears to have many advantages for your type of operation.

3. We note that the company now makes payroll payments by check. The time involved in maintaining payroll records could

be considerably reduced if a peg-board system were to be employed whereby the check, payroll, employee pay slip, and employee earnings record are all prepared in one operation. Additional time could also be saved by opening a separate payroll bank account, and by placing the payroll on a biweekly basis.

4. We believe that many of the operations relating to cash disbursements, cash receipts, sales and sales statistics, billing, and the inventory operation might be done better—at a lower cost to the company—by the use of bookkeeping machines instead of the present hand process methods. For example, the installation of a machine bookkeeping system will save many hours of work now spent locating trial balance differences. The controller has informed us that the company's one bookkeeping machine is used exclusively for posting accounts receivable ledger cards, and that machine time is not presently available for other work. We suggest in this connection that consideration be given to eliminating the posting of customers' ledger cards in favor of an open invoice file for accounts receivable. We believe that the adoption of such a system could save considerable clerical time in the accounting department without the loss of accounting control. We believe further that a system of this type would greatly enhance the efficiency of the credit and collection system which is presently handicapped because of failure to promptly post customers' charges to the receivable cards.

In view of the improved methods and applications of machine accounting made in recent years, we suggest that the company survey its present accounting methods to determine whether any of the newer accounting equipment would be of benefit to the company. Our management controls department is experienced in this type of work and will be glad to assist you in making the survey.

Sales

Based on comparison of the relative cost of your sales effort to the operations of similarly situated companies in your industry, it is our opinion that reductions in costs could be realized through more effective control of your sales activity. The sales effort costs more than $470,000 annually. Of the present annual sales of $4.5 million, we note that no more than $2.5 million are sold through the field force activity. A comparison of your sales to sales-cost relationship with operating ratios attained by similarly situated members of your industry indicates that Foley's sales costs are either excessive or not effectively employed. It is suggested that a review of the sales-sales cost relationship be immediately instigated by management and a goal of beating the industry average in respect of this cost relationship be established.

We are not including in the foregoing certain laboratory costs insofar as they relate to technical service support for the sales department. The cost of servicing requests by the sales department is considerable. We note, however, that no time or expense controls are provided over this function. Further, it appears that the sales department makes indiscriminate requests of the laboratory. Your laboratory chief estimates that 25 per cent of the cost of this activity is wasted. We estimate that technical customer service activity represents an annual cost approximating $60,000 or more, and therefore we recommend a re-examination of the policies governing this activity. It could yield substantial benefits to the company.

We noted further that the sales department is incurring significant sample making and sample shipping costs. It is our belief that the greater part of this cost is incurred on behalf of people and companies which do not appear to warrant the effort. Approximately 80 per cent of the cost of this activity last year was expended on behalf of customers that accounted for only 15 per cent of Foley's sales. The cost of this activity approximated $74,000 during the last annual period and we believe the company might get more sales value for less expenditure. We suggest that management reappraise its sample program and its controls over this activity to determine if savings can be effected. It would be unrealistic and improper for us to assert categorically that some definite dollar figure represents a safely predictable figure of increased profit from a revision of policy. However, our appraisal of the foregoing indicates that informed and reformed managerial effort and control could successfully extract some profit. You and your management associates will necessarily be the judges of this.

Financial management

We note that it is an approved policy of the company to defer payment on most purchases to such an extent that cash discounts are seldom taken. The aggregate amount of cash discounts missed represents a substantial loss to the company each year, and appears to be considerably greater than the amount of interest which might be incurred in the financial arrangements necessary to make payments within various discount periods. We recognize that the company's financial structure is under continuing study by the management, but it is our opinion that the present financial position of the organization merits more favorable consideration by lending agencies which could produce the necessary funds to enable the company to take advantage of the profitable discounts.

Fixed assets

There is no formal policy in effect with respect to the authorization of expenditures for property, plant and equipment. Policies with respect to the establishment of depreciation rates do not appear to be uniform, and we also noticed that the rates of depreciation being used are not consistent within the company. We suggest that management review the entire policy with respect to the authorization of expenditures for property, plant and equipment and the depreciation policies relative thereto.

In our letter of October 19, we made certain recommendations with respect to initiating the use of a fixed asset ledger in order to more effectively safeguard these assets. The accounting department subsequently prepared a statement of fixed assets at December 31, which we were unable to verify because of the lack of supporting records. Due to the company's very large investment in such assets and the effect that they have upon the financial position of the company as a whole, we again recommend that complete and accurate fixed asset records be installed. This could be accomplished by an inventory or appraisal performed by independent appraisers or by a selected group of Foley Company employees working under close supervision.

Personnel

IN CONNECTION WITH our examination, we observed that the responsibilities of the various supervisory employees are not precisely defined and that the assumption of duties and responsibilities by supervisors has been determined by custom and practice. This appears to result from deficiencies in the organizational structure and failure in the past to prepare and utilize an effective organization chart as well as procedure manuals as mentioned later in this letter. We recommend that an organization plan be adopted which will delineate the authority and responsibilities of the various supervisory employees of your organization.

We further observe that periodic reappraisals of clerical operations and functions are not being made to determine that each clerical employee is fully employed on useful operations. An unusual degree of idle and nonproductive time was observed by our representatives during their assignment in your office, and we recommend that the study of organizational structure should not be allowed to stop at supervisory levels but that it should extend to lower levels as well in order to recoup what appears to be wasted cost.

Budgeting and forecasting

WE HAVE NOTED THAT THE COMPANY has not adopted regular procedures for forecasting and budgeting future operations. It is understood that the nature of the company's operations makes predictions of the future difficult and subject to frequent change. However, this very circumstance tends to make forecasting and budgeting more desirable. We recommend that the company in the future prepare annual budgets which include monthly figures on income and expense and, in connection with the budgeting for profits, that it prepare cash forecasts which include monthly figures for receipts and disbursements. As a part of the budget procedure, monthly financial statements should be presented comparing actual against budgeted figures, together with appropriate monthly analyses of exceptions. We believe that you and other members of the top management group would find that "managing by exception" through budgeting would be a profitable, as well as a time-saving, feature in directing and controlling the over-all operations of Foley Company.

Insurance coverage

WE NOTE THAT THE OFFICERS, as well as other employees, frequently use their personal automobiles in company business, such as going to the bank, post office, suppliers and so on. There is no record of insurance coverage on automobiles other than those owned by the company. Claims could likely arise against the company in the event of a serious accident involving liability. We suggest that protection against such a contingency should be provided by adequate insurance.

The company should review its use and occupancy insurance coverage to determine whether the present policies are of benefit to the company. In view of the fact that operating losses have been sustained in recent years, it appears advisable to review the amount of coverage and the potential risk involved. We suggest, too, that appropriate consideration be given to a newer type of "block policy" which, from our experience with other clients, has often produced a substantial saving in premium costs.

We note that the company does not carry products liability insurance. It is our opinion that your company is definitely exposed to a risk of this nature and it is our suggestion that management attention be directed to the desirability of adding such coverage.

We have been informed that the most recent survey of the insurance coverage was conducted over three years ago. We recommend that this be done in the future on a more frequent basis.

Use of company manuals

It is appreciated, of course, that no system of internal control will function effectively unless all personnel are impressed with their responsibility in connection with the performance of specific assignments. The same is true in respect to management controls. One method of obtaining best results would be to prepare procedural manuals for use in the various departments. These manuals should explain in detail the duties of each employee and the responsibility and authority delegated to him. The employees should understand that they will be accountable for all deviations from prescribed procedures.

Purchasing

Our review of the material and supply products cards disclosed that economic lots have not been established for most of the items the company purchases, thereby foregoing the advantages obtainable from organized "economic lot buying."

Our review of material and supply inventory cards also disclosed a lack of re-order points so that at times supply procurement had become urgent and emphasis had to be placed on delivery and not the price of the particular items.

We noted, too, that quantities of some of the major classes of items purchased were *first* brought to the attention of the purchasing department only as the need for such materials arose and notification came only through the medium of a purchasing requisition. In view of the significant dollars disbursed for these items, we suggest that the purchasing department be notified earlier in the year of the over-all anticipated yearly requirements so that annual inventory requirements, as well as proper levels for these items, may be programmed in relation to market conditions, availability of supply, delivery time, production scheduling, and so forth. This would, of course, be related to the budgeting procedures we have recommended be adopted.

We note, too, that not all procurement is centralized in the purchasing department. We recommend, therefore, that the policies governing the purchasing activity of the company be reviewed.

Summary

THIS LETTER, of course, does not provide a complete survey of all of the phases of operating and management controls, but merely directs attention to certain aspects which we believe to be especially worthy of management consideration. We appreciate further that the ultimate objective of management is to provide maximum control at minimum cost. We believe that correction of the deficiencies enumerated in this letter will be compatible with that objective.

We will be pleased, of course, to discuss the foregoing with you, the Board, or others of the Foley Company as you so direct, and to assist in the implementation or correction of any of the foregoing management controls.

Sincerely,

AN ILLUSTRATION OF THE QUALIFICATIONS DESIRED OF A MANAGEMENT SERVICES STAFF MAN

A CPA FIRM, with many years of experience in management services work, has prepared a short description of the qualifications of a management services staff man. In addition to seeking these qualifications in personnel recruited outside the firm, it is also utilized within the firm in order that audit staff men who hold the basic qualifications may be spotted and, in turn, developed more quickly for permanent transfer to the management services staff.

The CPA firm without extensive experience in management services work might valuably test the basic qualifications of its audit staff by reference to this description—with the thought, of course, that further emphasis on development of the staff men they find to be basically qualified will logically result in a firm's ability to gradually build the staff through which a wider scope of management services may be offered to clients in the future.

Furthermore, for the benefit of the CPA who has believed that a management services man must have extremely specialized talents, certain statements have been underscored in order to emphasize that *high degrees of specialization are not the basic factors of qualification.* It is ventured that many practitioners and small firms can point to men on their audit staffs who are admirably endowed with the basic qualifications and who, if provided with further training, could become competent management services staff men.

Education

Degree from accredited college or university is required. Major study concentration, preferably in accounting, and graduates with major study in management or engineering must have some courses in, or knowledge of, accounting. Postgraduate courses or study in fields such as management, business machines, electronics and systems and procedures are considered favorably.

Experience

Management consulting or methods and procedures *experience is desirable but not required.* A good depth of business experience and understanding is required.

Experience which has involved contact with administrative and executive personnel, and which has required personal initiative rather than closely directed effort is preferred. *Evidence of having developed programs and written statements of proposals, and of having participated in the implementation and installation of such programs is considered advantageous.*

Personal attributes

A consultant must be able to work and communicate harmoniously and in a competent and business-like manner with personnel at all organizational levels. He must be personable and diplomatic, yet have an inquiring approach and be an aggressive and diligent worker. He should have a high degree of intelligence, be imaginative and have the capacity to proceed without close direction. He must be able to develop sound ideas clearly and logically, both orally and in writing, and have good persuasive abilities.

Work on assignments usually breaks down into five phases. A qualified man, within the area of his specialization, should have the capacity to perform the following:

1. Obtain the facts pertinent to the problem or situation.

2. Analyze the facts.

3. Prepare a program of recommendations for correction or improvement.

4. Review the recommended program with management.

5. Assist in or perform the installation after the program is accepted.

General areas and nature of work

ASSIGNMENTS INVOLVE analyzing and developing solutions for a wide range of business problems which arise in client organizations. Many clients are industrial companies for whom the firm has performed accounting and financial services for a number of years.

Obviously, all staff members cannot be highly proficient in all areas in which management services work is performed. For this reason, a staff member usually will have developed special abilities in one or more specific areas, and will *have the necessary educational and experience background to enable him to recognize problems in other areas, and to broaden his abilities with added training and experience.* Examples of specific types of knowledge, training and/or experience which are considered advantageous are listed below:

Organization and Management Controls

General Accounting Methods and Procedures

Information Processing Methods

- Office Equipment and Methods (accounting machines, forms design, etc.)
- Tabulating and Electronic Computer Equipment and Methods

Costs and Budgets

Clerical Work Measurement

A BIBLIOGRAPHY OF REPRESENTATIVE SOURCES OF OPERATING STATISTICS BY INDUSTRY AND TRADE

THE FOLLOWING BIBLIOGRAPHY is basically a reproduction of materials distributed in connection with a talk given by the chairman of the committee on management services by CPAs at an annual meeting of the American Institute of CPAs.

This bibliography does not purport to be a complete, or even selective, listing of all that is available in the area of operating statistics. Its intent is to give an *idea* of what may be found by looking to trade associations, trade journals, commercial research organizations, university presses, and government agencies when information in a particular trade or industrial field is needed.

The studies listed in Sections I and II may be obtained by writing directly to the issuing agency and are available to anyone at the prices indicated. Prices are, of course, subject to change.

The studies listed in Sections III and V, which deal primarily with the offerings of trade associations, are sometimes available only to members of the association. The American Institute's library, however, can loan to Institute members copies of the published ratios of all of these associations. Members of the American Institute are urged to utilize the library's facilities. For reference to information on industries or trades not covered in this bibliography, the library staff will also be pleased to assist members in suggesting sources.

A number of the studies in Sections III, IV and V carry a charge, some nominal, while others cost as much as $50. It is suggested that the nature of such charges be determined before materials are ordered.

TABLE OF CONTENTS

I – MANUFACTURING LINES

Dun and Bradstreet, Inc.

Fourteen important ratios with interquartile range for seventy-two lines of business activity. (In: Foulke, Roy A., *Current Trends in Terms of Sale,* Dun and Bradstreet, Inc., 99 Church Street, New York 8, New York. No charge.) (Also printed separately.)

Businesses, and Extent of Sample Used:

Airplane Parts and Accessories (38)
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Petroleum, Integrated Operators (37)
Printers, Job (64)
Shirts, Underwear and Pajamas, Men's (58)
Shoes, Men's, Women's and Children's (107)
Steel, Structural Fabricators (sell on short term) (101)
Stoves, Ranges and Ovens (56)

Robert Morris Associates

Statement studies: Part I, Basic Study. Part II, Income Supplement. Robert Morris Associates, Philadelphia National Bank Building, Philadelphia 7, Pennsylvania. $10.

Major Manufacturing Areas:

Food
Beverages and Tobacco
Textile Mill Products
Apparel
Leather and Leather Products
Lumber Products and Furniture
Paper and Paper Products
Printing and Publishing
Chemicals and Chemical Products
Rubber Products (except tires)
Stone and Clay Products
Iron and Steel Products
Electrical Machinery and Equipment
Nonelectrical Machinery and Equipment
Transportation Equipment
Nonferrous Metals and Products
Instruments
Jewelry
Toys and Novelties

United States Federal Trade Commission

Quarterly Financial Report for Manufacturing Corporations. Government Printing Office, Washington 25, D. C. $1.

II–TRADE LINES–VARIOUS

Accounting Corporation of America

Mail-me-Monday Barometer of Small Business. Accounting Corporation of America, 1929 First Avenue, San Diego, California. $12.50.

Business Types (Retail):

Motels
Barber and Beauty Shops
Repair Services
Contractors – Specialty
Men's and Women's Apparel
Laundry and Cleaning Agencies
Florists
Jewelry Stores
Photographic Supply Stores
Garages
Plumbing and Heating Equipment
Bakeries
Laundry and Cleaning Plants
Dairies
Feed, Fuel and Ice Dealers
Sporting Goods
Automotive, Miscellaneous
Specialty Food Stores
Paint, Glass, Wallpaper Stores
Men's Specialty Apparel
Gift and Novelty Shops
Auto Parts and Accessories
Confectionery Stores
Hardware Stores
Lumber and Building Materials
Drug Stores
Cocktail Lounges
Children's Stores
Appliance Stores
Liquor Stores
Nursery and Garden Supplies
Music Stores
Taxi Cabs
Shoe Stores
Furniture Stores
Service Stations

Restaurants
Variety Stores
Meat Markets
Women's Specialty Apparel
Used Car Dealers
Contractors–Building
Combination Grocery Stores
New Car Dealers
Medical Doctors
Dentists
Other Professions
Transportation, Other
Upholsterers
Machine Shops
Taverns

Dun and Bradstreet, Inc.

Fourteen important ratios with interquartile range for seventy-two lines of business activity. (In: Foulke, Roy A., *Current Trends in Terms of Sale.* Dun and Bradstreet, Inc., 99 Church Street, New York 8, New York. No charge.) (Also printed separately.)

Retail Trade Lines, and Extent of Sample Used:

Clothing, Men's and Boys' (162)
Clothing, Men's and Women's (91)
Department Stores (447)
Dry Goods (77)
Furnishings, Men's (43)
Furniture, 50 per cent or more, installment (147)
Groceries and Meats, Chain (53)
Groceries and Meats, Independent (48)
Hardware (42)
Lumber and Building Materials (130)
Shoes (80)
Women's Specialty Shops (203)

Wholesale Trade Lines:

Automobile Parts and Accessories (175)
Baked Goods (49)
Cigars, Cigarettes and Tobacco (85)
Drugs and Drug Sundries (69)
Dry Goods (156)

Electrical Parts and Supplies (129)
Fruits and Produce, Fresh (50)
Furnishings, Men's (31)
Gasoline, Fuel Oil and Lubricating Oil (42)
Groceries (255)
Hardware (200)
Hosiery and Underwear (39)
Household Appliances, Electrical (100)
Iron and Steel Sheets, Strips, Bars and Plates (60)
Lumber (91)
Lumber and Building Materials (87)
Meat and Poultry (39)
Paints, Varnishes and Lacquers (32)
Plumbing and Heating Supplies (156)
Shoes, Men's, Women's and Children's (54)
Wines and Liquors (44)
Womenswear, Coats, Suits and Dresses (32)

National Cash Register Company

Expenses in Retail Businesses. National Cash Register Company, Main and K Streets, Dayton 9, Ohio. No charge.

Lines of Business:

Appliance and Radio-TV Dealers
Automobile Dealers
Auto Parts Dealers
Bakeries
Barber and Beauty Shops
Bars
Building Materials Dealers
Camera and Photographic Supply Stores
Candy Stores
Children and Infant Wear Stores
Clothing Stores (Family)
Cocktail Lounges
Delicatessens
Department Stores
Drug Stores
Dry Cleaners
Electrical Appliance Stores
Farm Supply Stores
Floor Coverings Stores
Florists
Furniture Stores

Garages
Garden Supply Stores
Gasoline Service Stations
Gift and Novelty Shops
Grocery Stores
Hardware Stores
Hotels
Jewelry Stores
Laundries
Liquor Stores
Meat Markets
Men's Wear Stores
Motels and Tourist Courts
Music Stores
Office Supply and Equipment Dealers
Package Liquor Stores
Paint and Wallpaper Stores
Shoe Stores (Family)
Specialty Stores (Women's Wearing Apparel)
Sporting Goods Stores
Super Markets
Toy Stores
Used Car Dealers
Variety Stores

Robert Morris Associates

Statement Studies: Part I, Basic Study. Part II, Income Supplement. Robert Morris Associates, Philadelphia National Bank Building, Philadelphia 7, Pennsylvania. $10.

Major Retail Trade Areas:

Food and Beverages
Department Stores, Dry Goods and Apparel
Drugs
Lumber, Fuel and Ice
Furniture
Autos and Accessories
Electrical Appliances and Supplies
Hardware, Paints and Wallpaper
Jewelry
Books and Office Supplies
Sporting Goods
Boats, Motors, Boating Equipment and Supplies
Photographic Equipment and Supplies

Music Stores
Road Machinery Equipment Dealers
Floor Coverings

Major Wholesale Trade Areas:

Food, Beverages and Tobacco
Textile Products and Apparel
Drugs
Florists
Lumber and Coal
Paper and Paper Products
Iron and Steel Products
Electrical Equipment
Industrial Chemicals
Machinery and Equipment
Automotive Parts and Accessories
Jewelry
Petroleum Products
General Merchandise

Services and Miscellaneous:

Laundries and Dry Cleaners
Soft Drinks (including bottling, wholesaling and retailing)

III—TRADE LINES—SPECIFIC

Appliance and Radio-TV

National Appliance and Radio-TV Dealers Association. Costs of doing business survey. Chicago, Illinois.

Automobiles

National Automobile Dealers Association. Operating averages for the automobile retailing industry. Washington, D. C.

Automotive Equipment

Motor and Equipment Manufacturers Association. Annual survey of 410 automotive wholesalers. New York, New York.

Motor and Equipment Wholesalers Association. Cost of doing business in the automotive wholesale industry. Chicago, Illinois.

Automotive Wholesalers

National Standard Parts Association. Comparative performance records and leading lines survey for wholesaler executives. Chicago, Illinois.

Beverages

National Beer Wholesalers' Association of America. Operating results for the wholesale beer trade. Chicago, Illinois.

Wine and Spirits Wholesalers of America. Annual operations survey. St. Louis, Missouri.

Building Ownership and Management

National Association of Building Owners and Managers. Office building experience exchange report—analysis of rental income and operating expenses. Chicago, Illinois.

Children's and Infants' Wear

Dun & Bradstreet, Inc., Public Relations and Advertising Department. Children's and infants' wear stores operating results. New York, New York.

Clothiers

National Association of Retail Clothiers and Furnishers. Men's wear stores annual survey of operating experience. Washington, D. C.

Clubs

Harris, Kerr, Forster & Company. Clubs in town and country. New York, New York.

Horwath & Horwath. City club operations. New York, New York.

Department Stores

Harvard University. Graduate School of Business Administration, Division of Research. Operating results of department and specialty stores, by McNair, Malcolm P. Boston, Massachusetts.

National Retail Merchants Association. Controllers Congress. Departmental merchandising and operating results by Flanel, Sam. New York, New York.

Druggists

Lilly, Eli and Company. The Lilly digest of retail drug-store income and expense statements. Indianapolis, Indiana.

National Wholesale Druggists' Association. Operating survey. New York, New York.

Dry Cleaners

National Institute of Dry Cleaning. Bulletin service—cost percentages. Silver Spring, Maryland.

Farm Equipment

National Retail Farm Equipment Association. Cost of doing business in the farm equipment retailing industry. St. Louis, Missouri.

Food Chains

National Association of Food Chains. Operating results of food chains, by England, Wilbur B. Boston, Massachusetts. Harvard University, Bureau of Business Research, Division of Research.

Furniture

National Retail Furniture Association. Furniture store operating experiences. Chicago, Illinois.

Grocers

United States Wholesale Grocers' Association. Survey of wholesale grocers' profit and loss figures. Washington, D. C.

Hardware

National Retail Hardware Association. Retail hardware survey. Indianapolis, Indiana.

Hotels

Harris, Kerr, Forster & Company. Trends in the hotel business. New York, New York.

Horwath & Horwath. Hotel operations. New York, New York.

Jewelers

American National Retail Jewelers Association. Operating statistics. New York, New York.

Laundries

American Institute of Laundering. Operating cost percentages of members of the American Institute of Laundering, Joliet, Illinois.

Lumber

Northeastern Retail Lumbermen's Association. Survey of cost of doing business of retail lumber and building material dealers of the northeastern states. Rochester, New York.

Northwestern Lumbermen's Association. Cost of doing business survey. Minneapolis, Minnesota.

Paint and Wallpaper

Retail Paint and Wallpaper Distributors of America. Marketing survey. St. Louis, Missouri.

Paper

National Paper Trade Association. Annual survey of paper merchants' operations. New York, New York.

Plumbing and Heating

Central Supply Association. Report of operating costs for plumbing and heating wholesalers. Chicago, Illinois.

Printing

Printing Industry of America, Inc. PIA ratios for better printing management. Washington, D. C.

Shoes

Shoe Service Institute of America. Shop operating cost study. Chicago, Illinois.

Sporting Goods

National Sporting Goods Association. Costs of doing business survey, by Snyder, Richard E. Chicago, Illinois.

Stationery and Office Equipment

National Stationery and Office Equipment Association. Cost of operations report. Washington, D. C.

Super Markets

Super Market Institute. The super market industry speaks. Chicago, Illinois.

Trade Associations

American Society of Association Executives. Operating ratio report for trade associations. Washington, D. C.

Variety Chains

Harvard University. Graduate School of Business Administration, Division of Research. Operating results of variety chains, by Hersum, Anita C. Boston, Massachusetts.

IV—RELATED REFERENCES

Foulke, Roy A. Practical financial statement analysis. ed. 4. New York, New York. McGraw-Hill Book Co., Inc., 712 pp.

Gale Research Company. Encyclopedia of American associations; a guide to national associations of the United States. Detroit, Michigan, 716 pp.

Neter, John and Wasserman, William. Fundamental statistics for business and economics. New York, New York. Allyn and Bacon, Inc., 638 pp.

Ratio analysis. (In: Wixon, Rufus, *Accountants' handbook*, ed. 4. New York, New York. Ronald Press, sec. 3, pp. 7-18.)

United States. Small Business Administration. Ratio analysis for small business by Sanzo, Richard. Washington, D. C. Small Business Administration, 53 pp. *(Small Business Administration Series No. 20.)*

V—SOURCES OF INFORMATION

Individual trade associations, as well as other organizations and publishers, have conducted single or recurring studies in a number of trades and industries. If you do not find the line of business in which you are interested among the foregoing entries, perhaps one of these associations or other issuing agencies will be able to help you locate pertinent ratio studies. Names and addresses of the publishers of such studies are:

American College of Apothecaries, 39th and Chestnut Streets, Philadelphia 4, Pennsylvania (Pharmacies).

American Meat Institute, Department of Marketing, 939 East 57th Street, Chicago 37, Illinois.

American Paper and Pulp Association, 122 East 42nd Street, New York 17, New York.

Heating, Piping and Air Conditioning Contractors Association, 45 Rockefeller Plaza, New York 20, New York.

Indiana University. Bureau of Business Research, Bloomington, Indiana.

International Association of Ice Cream Manufacturers, 910 17th Street, N. W., Washington 6, D. C.

Michigan, University of. Bureau of Business Research, Ann Arbor, Michigan.

National Association of (Cost) Accountants, 505 Park Avenue, New York 22, New York.

National Association of Furniture Manufacturers, 666 North Lake Shore Drive, Chicago 11, Illinois.

National Association of Insurance Agents, 96 Fulton Street, New York 38, New York.

National Electrical Contractors Association, 610 Ring Building, Washington 6, D. C.

National Lumber Manufacturers Association, 1319 18th Street, Washington 6, D. C.

National Paper Box Manufacturers Association, 1101 Liberty Trust Building, Philadelphia 7, Pennsylvania.

National Restaurant Association, 1530 North Lake Shore Drive, Chicago 10, Illinois.

National Shoe Retailers Association, 274 Madison Avenue, New York 16, New York.

United States. Department of Commerce, Business and Defense Services Administration, Washington 25, D. C.

Reference list for further study

THERE IS LITTLE reference material which provides over-all coverage of the review of management controls by CPAs. There are many articles, however, which suggest one or some of the ways in which a CPA may extend his regular work to a review of administrative or operational areas. These are too numerous to list in their entirety. For guidance in obtaining the best reference material on extensions to areas not covered in this bulletin, or in this reference list, the American Institute's library will welcome the opportunity to assist members.

"Management Services for Small Clients" by Ralph F. Lewis, CPA. *The Journal of Accountancy*, September 1960.

An article, by the chairman of the committee on management services by CPAs, which suggests specific methods for expanding practice beyond the traditional areas and which points up operational and administrative areas which in the small business can valuably be investigated in the course of the CPA's regular work.

"Management Services—A Local Firm Approach" by George S. Olive, Jr., CPA. *The Journal of Accountancy*, April 1960.

An article which lays down specific guiding principles for the CPA or smaller firm that wishes to "gear up" its activity in extending additional services to management. It describes one firm's successful experience in staffing for this purpose.

"Salesmanship in Accounting Practice" by John W. LaFrance, CPA. *The Journal of Accountancy*, September 1959.

An article which explains several successful techniques for best presenting to management the need for correction of deficiencies located through the extension of the CPA's regular work.

"The Income Statement as a Management Tool" by Arthur Witte, CPA. *The Journal of Accountancy,* October 1959.

An article which illustrates a specific technique by which the income statement, almost always inspected or prepared as a part of the regular work, may be converted from an historical report to a modernized tool with which to uncover deficiencies in management controls.

The Internal Auditor, published quarterly by The Institute of Internal Auditors, 120 Wall Street, New York 5, New York.

This magazine is the journal of The Institute of Internal Auditors. The progressive internal auditor has for several years been involved in what this group has labeled "operational auditing," and this publication continuously includes articles on the subject. While the approach of the internal and independent auditor are, of necessity, at some variance, and while the internal auditor is generally concerned with the operations of larger businesses, the articles dealing with operational auditing can be of considerable value to practicing CPAs. Among the best articles on the subject which have appeared in *The Internal Auditor* recently are:

"The Operational Audit—An Extension of Management Controls," by Dr. R. E. Seiler, March 1959.

"Operational Auditing," by Bradford Cadmus, March 1960.

"Managerial Auditing of Operations," by Charles Inman, June 1958.